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Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1996

Hughes & Luce, L.L.P.,
Alan J. Bogdanow,
Tax Matters Partner,

Petitioner

v.

Commissioner of Internal Revenue,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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60 pp

QUESTION PRESENTED

Whether the tax benefit rule requires a taxpayer to include in its gross income the repayment of loans which were advanced by the taxpayer in earlier years for which the statute of limitations has closed, where the taxpayer erroneously deducted the loan advances in the years now barred by the statute of limitations.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

OPINIONS BELOW 1

STATEMENT OF JURISDICTION 2

STATUTORY PROVISION INVOLVED 2

STATEMENT OF THE CASE 2

REASONS FOR ALLOWING THE WRIT 6

I. THE DECISION OF THE FIFTH CIRCUIT DIRECTLY CONFLICTS WITH THE DECISION OF ANOTHER COURT OF APPEALS 6

II. THE DECISION OF THE FIFTH CIRCUIT DIRECTLY CONFLICTS WITH THE DECISION OF THIS COURT IN HILLSBORO NATIONAL BANK V. COMMISSIONER, 460 U.S. 370 (1983) 16

CONCLUSION 21

APPENDIX A A-1
APPENDIX B B-1
APPENDIX C C-1

TABLE OF AUTHORITIES

Page

A. Cases

Askin & Marine Co. v. Commissioner,
66 F.2d 776 (2d Cir. 1933).. 12

Canelo v. Commissioner,
53 T.C. 217, aff'd on other grounds,
447 F.2d 484 (9th Cir. 1971); 9,12,13

Capital Nat'l Bank of Sacramento v. Commissioner,
16 T.C. 1202 (1951).....14, 15

Commissioner v. Liberty Bank & Trust Co.,
59 F.2d 320 (6th Cir. 1932). 8

Crosley Corp. v. U.S.,
229 F.2d 376 (6th Cir. 1956);. 14

Dobson v. Commissioner,
320 U.S. 489 (1943); 11

Gmelin v. Commissioner,
55 T.C.M. (CCH) 1411 (1988), aff'd without op.,
891 F.2d 280 (3rd Cir. 1989).....9

Hillsboro National Bank v. Commissioner,
460 U.S. 370 (1983).....11,16,17,18,19,20

Kahn v. Commissioner,
108 F.2d 748 (2d Cir. 1940).. 8

Northwestern States Portland Cement v. Huston,
126 F.2d 196 (8th Cir. 1942), ...7,9,10,12,13

Union Trust Co. v. Commissioner,
1 F.2d 60 (7th Cir.), cert. denied, 311 U.S. 658 (1940),.....7

Unvert v. Commissioner,
656 F.2d 483 (9th Cir. 1981),
cert. denied, 456 U.S. 961 (1982),.....6,7,12

B. Statutes

26 U.S.C. § 61.....2,C-1,C-2

26 U.S.C. § 1016(a)(1) 15

26 U.S.C. § 1016(a)(2) 15

26 U.S.C. 1254(1).....2

C. Secondary Authorities

2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS (2d Ed. 1990).....15

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PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the U.S. Court of Appeals for the Fifth Circuit is reported at 70 F.3d 16 (5th Cir. 1995) and is reproduced in Appendix A. The opinion of the U.S. Tax Court is reported at

68 T.C.M. (CCH) 1169 (1994) and is reproduced in Appendix B.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit in this case was entered on November 15, 1995. No rehearing has been sought or ordered, and no request for an extension of time within which to file this petition for certiorari has been made. This Court has jurisdiction to review the judgment of the United States Court of Appeals for the Fifth Circuit under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

26 U.S.C. § 61 (full text reprinted in full in Appendix C).

STATEMENT OF THE CASE

The Commissioner of Internal Revenue has asserted herein that Hughes & Luce, L.L.P. ("Petitioner") must include in its 1989 taxable income $422,457 which it received as reimbursements from clients for certain out-of-pocket costs paid to third parties in previous years in connection with client business. These costs include items such as travel and meal expenses, court costs, filing fees, expert fees and costs, corporate service charges, third party

photocopy services, deposition expenses, long-distance telephone charges, delivery services, and like costs incurred while representing those clients ("Service Costs").

Until the audit commenced this case, Petitioner always treated Service Costs as deductible business expenses in the year paid and as taxable income in the year reimbursed. For 13 years, the firm consistently identified the Service Costs on its tax returns as items paid and passed through to clients. Each return plainly disclosed this treatment. The Commissioner never audited or otherwise objected to Petitioner's returns. Nothing prevented the Commissioner from conducting an audit.

During or before the audit of Petitioner's 1989 tax return, the statute of limitations expired as to all of Petitioner's pre-1989 tax years. In the audit, the Commissioner determined that Petitioner had been treating Service Costs as set forth above and identified the Service Costs and their treatment merely by reviewing the Petitioner's tax returns. The Commissioner determined that Petitioner's Service Cost deductions were erroneous when taken, and that no event took place subsequent to

the time the Service Cost deductions were taken that made the deductions improper.

The Commissioner asserted that Petitioner's Service Costs are properly treated as loans to clients. Under the Commissioner's approach, Petitioner cannot deduct the Service Costs as business expenses in the year incurred, and should not include in income subsequent reimbursements. Rather, the payment of a Service Cost by Petitioner is a non-deductible loan to its client, and the repayment of a Service Cost is a tax-free return of principal on the debt. The Commissioner applies her theory to Service Costs paid and reimbursed in 1989 and all subsequent years, but inconsistently requires Petitioner to include in income all amounts received in 1989 for reimbursement of pre-1989 Service Costs which were deducted in years now closed by the statute of limitations. The Commissioner's position is that the tax benefit rule requires such inclusion in income, and generally applies to the recovery of any previously deducted expenditure without regard to whether the deduction was proper or erroneous.

Petitioner agreed that it erroneously deducted the Service Costs in 1989 and previous years, and agreed to report Service Costs as loans -- as the Commissioner desired. Petitioner contends that since the reimbursements received in 1989 for pre-1989 Service Costs are properly treated as repayment of loan principal, they cannot be included in taxable income. The Commissioner should be consistent in her treatment of loan repayments in all years. The tax benefit rule is not applicable to the recovery of erroneously deducted expenditures where nothing prevented the Commissioner from exercising her remedy with regard to those erroneous deductions, which is to assess deficiencies for the appropriate years before the statute of limitations expired.

The U.S. Tax Court agreed with Petitioner that the tax benefit rule does not apply to the recovery of erroneously deducted expenditures, but ruled against Petitioner on other grounds.[1] On

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[1] The memorandum opinion of the U.S. Tax Court (Judge David Laro), filed November 3, 1994, held (i) that the tax benefit rule does not force Petitioner to include the reimbursement of previously deducted Service Costs in

appeal, the U.S. Court of Appeals for the Fifth Circuit reversed the Tax Court on the tax benefit rule issue, and specifically rejected the application of the so-called erroneous deduction exception to the tax benefit rule.[2]

REASONS FOR ALLOWING THE WRIT

I. THE DECISION OF THE FIFTH CIRCUIT DIRECTLY CONFLICTS WITH THE DECISION OF ANOTHER COURT OF APPEALS.

Three courts of appeals have decided cases based directly on the issue presented in this case. The United States Court of Appeals for the Fifth Circuit in the present case, and the United States Court of Appeals for the Ninth Circuit in Unvert v.

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income after expiration of the statue of limitations because the deduction of the Service Costs was made in error and the tax benefit rule does not apply to recoveries of erroneous deductions; and (ii) that the doctrine of quasi-estoppel, or the "duty of consistency," requires Petitioner to include in income in 1989 reimbursements received for previous years' Service Costs.

[2] Because its ruling on the tax benefit rule issue disposed of the case, the Fifth Circuit did not need to, and did not, address the quasi-estoppel doctrine relied on by the Tax Court.

Commissioner, 656 F.2d 483, 485-86 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982), have held that the tax benefit rule applies to require a taxpayer to include in income the recovery of a previously deducted item even if the prior deduction was erroneous when taken.[3] The United States Court of Appeals for the Eighth Circuit, in Northwestern States Portland Cement v. Huston, 126 F.2d 196, 200-01 (8th Cir. 1942), held that a taxpayer was not required to include in income the recovery of an erroneously deducted item, and that the Commissioner's remedy was to correct

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[3] Another case, Union Trust Co. v. Commissioner, 1 F.2d 60, 61 (7th Cir.), cert. denied, 311 U.S. 658 (1940), is frequently cited as indicating that the U.S. Court of Appeals for the Seventh Circuit is also opposed to the erroneous deduction exception to the tax benefit rule. In Union Trust, the court held that a refund of federal estate taxes must be included in taxable income where an additional assessment of state inheritance taxes which gave rise to the refund had been erroneously deducted on the income tax return. While the case may be indicative of the Seventh Circuit's views, it does not directly involve the recovery of the same expenditure item that was erroneously deducted, as do the other cases cited in the text.

the error in the year it was made before the statute of limitations expired. In addition, two other courts of appeals have decided tax benefit rule type cases on other grounds, but discussed the issue presented in this case in dicta, in each case suggesting that they would apply tax benefit rule principles and reject the erroneous deduction exception favored by the Eighth Circuit.[4] Because this is a tax case, it is also important to note that the United States Tax

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[4] Kahn v. Commissioner, 108 F.2d 748, 749 (2d Cir. 1940); Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320, 325 (6th Cir. 1932). Kahn and Liberty Bank both involved the recovery of a debt previously deducted as worthless. In Liberty Bank, the Sixth Circuit decided the case on estoppel grounds, but went on in dicta to indicate that the recovery would be taxable even if estoppel were not applicable. In Kahn, a case primarily concerned with whether certain debts were deductible or not, the Second Circuit noted in the last paragraph of the opinion that the issue of excluding from income the recovery of debts previously, and possibly erroneously, deducted had been argued on appeal but not raised in the court below. Nevertheless, the court indicated that assuming the issue could be considered, the recovery must be included in income.

Court has consistently ruled that the tax benefit rule is inapplicable to recoveries of erroneously deducted items. Canelo v. Commissioner, 53 T.C. 217, 226-27, aff'd on other grounds, 447 F.2d 484 (9th Cir. 1971); Gmelin v. Commissioner, 55 T.C.M. (CCH) 1411 (1988), aff'd without op., 891 F.2d 280 (3rd Cir. 1989).

Based on the Eighth Circuit's specific discussion of this issue in Northwestern States Portland Cement and the similarity of the facts in that case to this case, the Eighth Circuit is directly in conflict with the Fifth Circuit's opinion in this case. The taxpayer in Northwestern States Portland Cement sold cement, and, in conjunction with those sales, sold and repurchased the cement sacks which carried the product. Northwestern States Portland Cement, 126 F.2d at 200-01. In order to insure the availability of funds to repurchase the cement sacks in later years, the taxpayer established "reserves for loss on sacks." The taxpayer erroneously reduced its taxable income by deducting the additions it made to this special reserve account. Id. The Commissioner argued that a

restoration of a portion of the reserve account to surplus in a later tax year should give rise to taxable income to the taxpayer. This argument (which is identical to the Commissioner's argument in the present case) was specifically rejected by the Eighth Circuit. The court ruled that the Commissioner cannot "convert what was not taxable income for the year [at issue] into taxable income for that year" merely because the taxpayer recovered or restored a reserve which had been erroneously deducted in earlier years, even though the statute of limitations bars the Commissioner's sole remedy to correct the improper deductions for those earlier years. Id. at 201.

This analysis by the Eighth Circuit in Northwestern States Portland Cement is directly adverse to the Fifth Circuit's opinion in this case. Here, the Fifth Circuit ruled that the "tax benefit rule requires taxation of a previously created tax benefit . . . regardless of whether the original deduction was proper or improper." Hughes & Luce, 70 F.3d at 20. Thus, there is a direct conflict among the courts of appeals on this issue (as well as between the Tax Court and certain courts of appeals).

The conflict among the courts of appeals will recur and needs to be resolved by this Court. Although universally acknowledged as an important federal tax doctrine, the applicability of the tax benefit rule in special circumstances has been a continuing source of controversy. See, e.g., Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983); Dobson v. Commissioner, 320 U.S. 489 (1943). Tax benefit rule issues recur because the annual accounting system on which federal income tax laws are based draws arbitrary lines between taxable years. As a result, situations necessarily arise in which the taxpayer may be required to report income or may be entitled to claim deductions for a particular year even though events occurring in a subsequent year may affect the amount of income actually enjoyed or the liabilities or losses ultimately incurred. The issues presented by the tax benefit rule are fundamental to this annual accounting system.

Conflicts arise in the tax benefit rule's application in part because of a difference in view of whether the rule is a narrowly crafted remedy necessary to deal with unexpected events that arise

in subsequent annual accounting years, or a broad based safety net designed to correct all erroneous tax benefits regardless of the statute of limitations.[5] The conflict among the courts of appeals

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[5] Another reason the courts conflict is that some courts, like the Commissioner, have been troubled by the so-called "windfall" that results to the taxpayer when it receives a recovery for an erroneously deducted item. See Unvert, supra, (citing Askin & Marine Co. v. Commissioner, 66 F.2d 776 (2d Cir. 1933). The "windfall" is that the taxpayer has had the benefit of a tax deduction, but economically has not suffered any loss or expense. Other courts have recognized that this "windfall" results solely because the Commissioner permitted an erroneous deduction by allowing the applicable statute of limitations to close. See Northwestern States Portland Cement, supra; Canelo, supra. The "windfall" is not a reason to apply the tax benefit rule. Such a "windfall" results in every case in which a valid claim is foreclosed by the statute of limitations -- whether it be a claim for a deficiency by the Commissioner or a claim for a refund by a tardy taxpayer. If the Commissioner prevails in this case, what argument will be next -- that a taxpayer who claims a false deduction in a year closed by the statute of limitations is required by the tax benefit rule to include an offsetting amount of income in a subsequent year when he admits the deduction was false because he is economically enriched in

presented in this case contains these elements. In Northwestern States Portland Cement, the Eighth Circuit recognized that the Commissioner sometimes attempts to accomplish via the tax benefit rule what the statute of limitations does not allow it to do in the earlier years. 126 F.2d at 201. In this case, the Fifth Circuit ignores concerns over the integrity of the statute of limitations, and dismisses them because technically the earlier tax year in which the erroneous tax deduction was taken is not re-opened. Hughes & Luce, 70 F.3d at 20. Whether the integrity of the statute of limitations will be protected is another part of the conflict this Court needs to resolve.[6]

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that year by virtue of finally agreeing he never did nor ever will make the expenditure? The erroneous deduction exception to the tax benefit rule urged by Petitioner guards against this danger, as has been recognized by the Eighth Circuit in Northwestern States Portland Cement, and the Tax Court in this and other cases, see Canelo, supra.

[6] It is important to note that the Commissioner (unlike the taxpayer) is not left defenseless by the statute of limitations. The Commissioner has, at its disposal, the tax benefit rule to apply in those circumstances in which a

Finally, the decision of the Fifth Circuit in this case conflicts with the principle that the adjusted tax basis of an asset is not reduced when an erroneous loss deduction is taken with respect to the cost basis of that asset. See Crosley Corp. v. U.S., 229 F.2d 376 (6th Cir. 1956); Capital Nat'l Bank of Sacramento v. Commissioner, 16 T.C. 1202, 1213 (1951). Petitioner had basis in its Service Cost loans equal to the amount advanced, and the repayment of the loan is tax free because it offsets this basis. That

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subsequent event occurs that is fundamentally inconsistent with the premise on which a previous deduction had been taken where the Commissioner had no reason to question the prior deduction. The Commissioner also has the quasi-estoppel doctrine, or the duty of consistency, to preclude a taxpayer from voluntarily changing its position with respect to an erroneous item that was reported in a closed year to the Commissioner's detriment. The tax benefit rule should not be expanded to apply to those circumstances in which the Commissioner allowed an erroneous deduction under circumstances where the taxpayer's behavior does not give rise to any estoppel, and no subsequent event has occurred that has the effect of changing the factual assumptions on which the erroneous deduction was based.

basis is reduced by properly taken worthless bad debt deductions, but not by erroneous deductions.[7] Id. The Fifth Circuit's decision that income must be recognized upon the repayment effectively asserts that the earlier deduction reduced Petitioner's basis in the loan to zero, which is contrary to established law.

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[7] Reductions to basis of an asset for losses are only made for items "properly chargeable" to the asset. I.R.C. § 1016(a)(1). In contrast, reductions to basis for depreciation are made for all depreciation "allowed ... but not less than the amount allowable ...." I.R.C. § 1016(a)(2). The legislative history of this provision makes it clear that Congress intended to reduce basis for erroneous depreciation deductions. See 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶42.3 (2d Ed. 1990). However, the fact that the statute was amended to allow reductions in basis for erroneous depreciation deductions, but not other erroneous deductions, underscores the authority that no reduction is authorized in non-depreciation cases.

II. THE DECISION OF THE FIFTH CIRCUIT DIRECTLY CONFLICTS WITH THE DECISION OF THIS COURT IN HILLSBORO NATIONAL BANK V. COMMISSIONER, 460 U.S. 370 (1983).

In Hillsboro, this Court was called upon to determine whether the tax benefit rule only applied in circumstances where there was an actual recovery of some amount by the taxpayer. This Court rejected the requirement of an actual recovery, and held that the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction, whether the subsequent events constitute a recovery or not. Hillsboro, supra, 460 U.S. at 373.

Hillsboro makes a very clear statement that the tax benefit rule applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction. It is beyond reason to apply such a rule when no inconsistent events occur. In the present case, everything occurred as both the taxpayer and the Commissioner expected at the time the earlier tax returns were filed. Petitioner advanced amounts to clients, and the clients ultimately repaid them. The repayment is the only

subsequent event. But the repayment is not an event that is inconsistent with the erroneous deduction, because the deduction was not premised on the assumption that the loans would not be repaid. The erroneous deduction is simply a mistake which the Commissioner is required to correct within a statutory period of time.

Hillsboro elaborates on its "subsequent inconsistent event" requirement by stating that the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. Id. at 384. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction. Id. Petitioner believes that the court of appeals is clearly erroneous in finding that standard to be satisfied in this case. The court of appeals found that the actual recoveries by Petitioner were fundamentally inconsistent events in that they would have foreclosed the deduction had they occurred in the same year as the disbursements. That argument misses the point. It is not the actual recovery of the advances that foreclose the deduction

in this case. The deduction is foreclosed because loans are never deductible when made. This conclusion is always applicable in the case of an erroneous deduction. It is the error of improperly deducting an item in the first place that "forecloses the deduction." It is not the event in the subsequent year that retroactively makes the earlier deduction improper. Indeed, the entire concept that a subsequent event is "inconsistent" with or "makes" the earlier deduction improper assumes that the original deduction is properly taken.[8]

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[8] Hillsboro is filled with references indicating that the tax benefit rule applies to cases where there has been a change in circumstance after the original tax return was filed. This necessarily means that the original deduction was properly taken (as was the case in Hillsboro). The case referenced situations where "[t]he Government, by allowing a deduction that it could not have known to be improper at the time, would be foreclosed from recouping any of the tax saved . . . ." Hillsboro, supra, 460 U.S. at 378-79 (footnote and citations omitted). The footnote at the end of that sentence refers to situations where "the event proving the deduction improper closes after the close of the taxable year . . . ." Id. at 379 n.10. These are references to a properly taken deduction and a

In the present case, there has been no change in circumstance and no subsequent event which forecloses the earlier deduction. Petitioner's loans were expected to be repaid and they were in fact repaid. On its face, therefore, the Fifth Circuit's decision in this case is contrary to this Court's opinion in Hillsboro.

In any event, this case involves the interpretation of a judicial doctrine which has been clearly established by this Court.

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subsequent change in circumstance that retroactively makes it improper. Similarly, this Court notes that "[t]he purpose of the tax benefit rule is to achieve rough transaction parity in tax, . . . and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous . . . . " Id. at 383. Also, "Changes on audit reflect the proper tax treatment of items under the facts as they were known at the end of the taxable year. The tax benefit rule is addressed to a different problem -- that of events that occur *after* the close of the taxable year." Id. at 379 n.10. These references, too, indicate that the tax benefit rule applies to properly taken deductions and subsequently changed circumstances.

It is important for this Court, therefore, to grant this petition and address the application of this Court's articulated standard to the issue presented.

We note that all of the cases, except the instant case, which discuss the erroneous deduction aspect of the tax benefit rule were decided prior to this Court's decision in Hillsboro. Rather than wait for each court of appeals to re-examine their prior cases in light of this Court's new statement of the tax benefit rule in Hillsboro, this Court should clarify the interpretation of its earlier decision and establish a uniform national rule. Granting taxpayer's petition is in the best interest of the efficient administration of the tax laws and will save resources of both taxpayers and the government.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

February 13, 1996

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APPENDIX A

UNITED STATES COURT OF APPEALS
For the Fifth Circuit

No. 95-60036

HUGHES & LUCE, L.L.P.,
ALAN J. BOGDANOW, TAX MATTERS PARTNER,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court

Before REAVLEY, JOLLY, and WIENER, Circuit Judges.

WIENER, Circuit Judge.

This federal income tax case finds a law firm appealing from an adverse judgment rendered by the United States Tax Court. The underlying dispute arose when, during the course of an audit, the Internal Revenue Service (IRS) determined that "Service

Costs" deducted by Hughes & Luce, L.L.P. should be treated as nondeductible loans to clients. The instant controversy concerns the collateral issue of the proper tax treatment of currently received reimbursements of "Service Costs" previously deducted by the law firm as expenses in earlier tax years. The Tax Court upheld the IRS's adjustment to Hughes & Luce's then-current taxable income, holding that the duty of consistency requires Hughes & Luce to recognize income for these reimbursements. The Tax Court declined to apply the tax benefit rule, however, relying on the so-called "erroneous deduction exception." Agreeing with every other circuit court that has addressed the erroneous deduction exception, we conclude that it should be rejected, and that the judgment of the Tax Court should be affirmed but on the basis of the tax benefit rule.

I

FACTS AND PROCEEDINGS

Hughes & Luce, L.L.P. is a Texas general partnership engaged in the practice of law. It commenced doing business on

November 1, 1976. Hughes & Luce uses the cash receipts and disbursements method of accounting for income tax purposes and files its tax returns on a calendar year basis.

Although the terms of an engagement differ from client to client, Hughes & Luce customarily bills clients separately for out-of-pocket costs paid to third parties for expenses incurred in connection with the firm's representation of those clients. These costs include expenses for court costs, filing fees, expert witness fees, travel and meals, long-distance telephone charges, delivery services, and the like ("Service Costs").

On its income tax returns for the years 1976 through 1989, Hughes & Luce deducted Service Costs as ordinary and necessary business expenses in the year in which the expense was paid. Reimbursements of these costs were included in its ordinary income in the year received. Often the reimbursements were received in a taxable year subsequent to the year in, which the Service Costs had been deducted as business expenses.

On March 30, 1992, the IRS began an audit of Hughes & Luce's timely filed 1989 tax return. During the course of this audit, the IRS challenged Hughes & Luce's treatment of the Service Costs. The IRS contended that the firm's payments for Service Costs should be treated as loans to clients. Accordingly, the Service Costs should be neither deductible when paid nor includible in income when reimbursed. For purposes of this case, Hughes & Luce concedes that the Service Costs are properly treated as loans to clients for taxable year 1989 and following.

For the taxable year 1989, Hughes & Luce had deducted Service Costs in the amount of $2,367,535. [1] Reimbursements totaling $2,398,825 were included in income for this same year. Of the total reimbursements, $1,908,509 was attributable to Service Costs paid and deducted in 1989. The remainder of $490,766 was attributable to Service Costs paid and deducted in years prior to

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[1] The majority of these Service Costs were described on Hughes & Luce's income tax return as "Other Rebillable Expenses," and the remainder was interspersed among eighteen other categories of expenses.

1989.[2] It is these latter reimbursements that are at issue in this case. As the statute of limitations had expired for the years prior to 1989, the IRS was precluded from making an adjustment to those years to disallow the deduction of these Service Costs.

Hughes & Luce essentially contends that none of the reimbursements received in 1989 are taxable income because the IRS determined them to be loan repayments, and loan repayments are not ordinarily includible in income. The IRS counters that the reimbursements received in 1989 but attributable to costs advanced and deducted as expenses in years prior to 1989 are includible in taxable income for 1989 under either (1) the tax benefit rule or (2) the duty of consistency, which is also known as the doctrine of quasi-estoppel. On June 1, 1993, the IRS sent Hughes & Luce a Notice of Final Partnership Administrative Adjustment for its 1989

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[2] The parties have stipulated to the amounts above. As acknowledged by the Tax Court, the $450 discrepancy between the total reimbursements and the components thereof is immaterial for purposes of our decision.

tax year, reflecting an adjustment to its taxable income of $422,457.[3]

Hughes & Luce filed a petition in the Tax Court challenging the IRS's determination. The Tax Court held that, as the deductions for Service Costs in years prior to 1989 were improper, the tax benefit rule was inapplicable under the so-called "erroneous deduction exception." The court went on to hold, however, that Hughes & Luce was required to include the amount

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[3] The adjustment was calculated as follows:

Service Costs deducted but not reimbursed as of December 31, 1988		$490,766
Service Costs deducted in 1989	$2,367,535	
Service Costs reimbursed in 1989	(2,398,825)	(31,290)
Less: Bad debt deduction		(37,019)
Adjustment to Hughes & Luce's taxable income for 1989		$422,457

in issue in its income under the duty of consistency. Hughes & Luce now appeals that decision.

II

ANALYSIS

A. STANDARD OF REVIEW

In reviewing decisions of the Tax Court we apply the same standards used in reviewing a decision of the district court: Questions of law are reviewed de novo; findings of fact are reviewed for clear error.[4]

B. TAX BENEFIT RULE

The federal income tax is based on an annual accounting system, which is "a practical necessity if [it] is to produce revenue ascertainable and payable at regular intervals."[5] Strict adherence to an annual accounting period, however, may create transactional

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[4] Estate of Hudgins v. Commissioner, 57 F.3d 1393, 1396 (5th Cir. 1995).

[5] Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 377 (1983) (citing Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931)).

inequities.[6] The tax benefit rule was adopted in an equitable effort to mitigate some of the inflexibilities of the annual accounting system by approximating the results that would be produced in a system based on transactional rather than annual accounting.[7]

The tax benefit rule includes an amount in income in the current year to the extent that: (1) the amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion of gross income.[8] An event is fundamentally inconsistent with the premises on which the deduction was originally based if that event

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[6] Id.

[7] Id. at 377, 381.

[8] Id. at 383-84; Frederick v. Commissioner, 101 T.C. 35, 41 (1993).

would have foreclosed the deduction had it occurred in the year of the deduction.[9]

The Tax Court held that application of the tax benefit rule was improper in this case because of the "erroneous deduction exception." That exception provides that the tax benefit rule applies only when the original deduction was proper.[10] Because the disbursement of a loan (i.e., Service Cost) is not a proper deduction, the Tax Court concluded that the tax benefit rule did not require Hughes & Luce to include the amount in issue in its 1989 taxable income.

In its opinion, the Tax Court noted candidly that the erroneous deduction exception has been criticized or rejected by many Courts of Appeals.[11] The Tax Court nevertheless applied

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[9] Hillsboro, 460 U.S. at 383-84.

[10] See Canelo v. Commissioner, 53 T.C. 217, 226 (1969), aff'd on other grounds, 447 F.2d 484 (9th Cir. 1971).

[11] See Unvert v. Commissioner, 656 F.2d 483, 485-86 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982); Union Trust Co. v. Commissioner, 111 F.2d

this exception in the instant case because we had not squarely addressed this issue. We do so now and join the other circuits in rejecting the erroneous deduction exception.

The rationale underlying the erroneous deduction exception was explained by the Tax Court in Canelo as follows:

> We realize that [the taxpayers] herein have received a windfall through the improper deductions. But the statute of limitations requires eventual repose. The "tax benefit" rule disturbs that repose only if [the IRS] had no cause to question the initial deduction, that is, if the deduction was proper at the time it was taken. Here the deduction was improper, and [the IRS] should have challenged it before the years

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60, 61 (7th Cir.), cert. denied, 311 U.S. 658 (1940); Kahn v. Commissioner, 108 F.2d 748, 749 (2d Cir. 1940); Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320, 325 (6th Cir. 1932).

prior to 1960 were closed by the statute of limitations.[12]

Like the other Courts of Appeals before us, we are not persuaded by this reasoning or by the arguments advanced by Hughes & Luce in support of this exception.

As other courts have observed, the inclusion of the reimbursements in income does not reopen the tax liability for the prior years - albeit the result is much the same-and does not implicate the statute of limitations.[13] The only taxable year affected by application of the tax benefit rule is the year in which the reimbursements are received, which year must be open for the rule to apply at all. That these reimbursements are properly treated as loan repayments does not prevent their taxation when, as here,

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[12] Canelo v. Commissioner, 53 T.C. 217, 226-27 (1969), aff'd on other grounds, 447 F.2d 484 (9th Cir. 1971).

[13] Dobson v. Commissioner, 320 U.S. 489, 493 (1943); Unvert v. Commissioner, 656 F.2d 483, 485-86 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982).

the loan disbursements were erroneously deducted in a prior year as an expense. The tax benefit rule requires taxation because of a previously created tax benefit, regardless of an item's inherent characteristics (i.e., whether repayment of a loan or recovery of a deductible expense) and regardless of whether the original deduction was proper or improper.[14] We also agree with the court in Unvert that the erroneous deduction exception is poor public policy in that it rewards the taking of improper tax deductions. We therefore reject the erroneous deduction exception and conclude that the tax benefit rule applies regardless of the propriety of the original deduction.

Hughes & Luce argues that the Supreme Court's decision in Hillsboro National Bank v. Commissioner effectively overruled prior cases that rejected or criticized the erroneous deduction exception. Selectively pointing to language and examples in that case, Hughes & Luce asserts that Hillsboro leaves no doubt that the

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[14] Unvert, 656 F.2d at 486.

tax benefit rule can be applied only when the original deduction was proper. We disagree, finding this to be a strained interpretation of Hillsboro.

At issue in Hillsboro was whether the tax benefit rule was limited to situations in which a taxpayer recovers an amount previously deducted or, alternatively, whether it also applies when an event in a later year is fundamentally inconsistent with the premise on which the deduction was claimed.[15] Neither the propriety of the original deductions nor the validity of the erroneous deduction exception was ever in question in Hillsboro. Thus, we are unpersuaded by this argument.

Hughes & Luce also contends that there is no fundamentally inconsistent event in this case because the very nature of "rebillable expenses" is that reimbursement of such expenses is expected. Thus, Hughes & Luce insists, it is improper to invoke the tax benefit rule. This argument misses the mark. In

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[15] Hillsboro, 460 U.S. at 381.

holding that a fundamentally inconsistent event is a requirement to invoke the tax benefit rule, the Supreme Court in Hillsboro expanded that rule by refusing to limit it to situations involving an actual recovery. The actual recoveries by Hughes & Luce of the Service Costs at issue plainly are fundamentally inconsistent events in that they would have foreclosed the deduction had they occurred in the same year as the disbursements.[16]

C. DUTY OF CONSISTENCY

As we affirm the Tax Court on the basis that the tax benefit rule requires Hughes & Luce to include the amount at issue in its 1989 taxable income, we need not and therefore do not consider the Tax Court's holding that this same result is required under the duty of consistency. This should not be construed as either agreeing with or rejecting the Tax Court's treatment of that matter.

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[16] See Hillsboro, 460 U.S. at 383-84.

III

CONCLUSION

For the foregoing reasons, we reject the erroneous deduction exception and conclude that the tax benefit rule applies regardless of the propriety of the original deduction. We therefore affirm the Tax Court's judgment, albeit we do so on the basis of the tax benefit rule rather than on the reason expressed by the Tax Court.

AFFIRMED.

APPENDIX B

T.C. Memo. 1994-559:

UNITED STATES TAX COURT

HUGHES AND LUCE, L.L.P., ALAN J. BOGDANOW, TAX MATTERS PARTNER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17904-93. Filed November 3, 1994.

H, a cash method partnership that provides legal services, has always deducted from taxable income its payment of reimbursable client expenses. Following an audit of H's 1989 Form 1065, U.S. Partnership Return of Income, R recharacterized these payments as nondeductible loans and increased H's 1989 taxable income by $422,457 in order to reflect the amount of these payments that H had deducted in taxable years before 1989, and for which H was reimbursed in 1989. H concedes the correctness of R's recharacterization of the payments as loans, but disputes R's attempt to increase its 1989 taxable income.

Held: The Court will not reconsider its position on the erroneous deduction exception to the tax benefit rule. Held, further, the doctrine of quasi-estoppel negates the erroneous deduction exception so that H must include the $422,457 in its 1989 taxable income.

Vester T. Hughes, Jr. and J. Gregory Taylor, for petitioner.

John S. Repsis, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

LARO, Judge: Alan J. Bogdanow (petitioner), tax matters partner of Hughes & Luce, L.L.P. (Hughes), petitioned the Court on August 19, 1993, to readjust respondent's $422,457 adjustment to Hughes' 1989 taxable income. Respondent's adjustment is reflected in a notice of final partnership administrative adjustment issued to Hughes on June 1, 1993. Respondent's adjustment stems from her recharacterization of Hughes' payment of reimbursable client expenses from deductible expenses to nondeductible loans.

Following petitioner's concession that respondent's recharacterization is correct, we must decide the following issues:

1. Whether the Court will reconsider its position on the erroneous deduction exception to the tax benefit rule. We hold that the Court will not.

2. Whether the doctrine of quasi-estoppel requires Hughes to include in its 1989 taxable income its receipt during 1989 of

$422,457 in reimbursements for these previously deducted client expenses. We hold that the doctrine does.[1]

FINDINGS OF FACT

Most of the facts have been stipulated and are so found. The stipulations and exhibits submitted therewith are incorporated herein by this reference. Hughes is a general partnership that was organized on November 1, 1976, under the laws of the State of Texas. When the petition was filed, Hughes' principal place of business was Dallas, Texas.

Hughes is a full-service civil law firm that uses the cash receipts and disbursements method of accounting for Federal income tax purposes and reports its income and expenses on a

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[1] Respondent also argued that the $422,457 adjustment is includable in Hughes' 1989 taxable income under sec. 481, I.R.C., because Hughes changed its method of accounting with respect to these client expenses. Based on our holding that the doctrine of quasi-estoppel requires Hughes to include this amount in its 1989 income, we do not decide whether sec. 481, I.R.C., also applies to the facts at hand.

calendar year basis. With respect to the taxable year in issue, Hughes timely filed a 1989 Form 1065, U.S. Partnership Return of Income.

Hughes has many clients, and its terms of engagement differ from client to client. Hughes' billing arrangements for its services include hourly fees, fixed fees per project, contingent fees, value-based fees, and a combination of the above. Hughes also bills clients separately for out-of-pocket costs paid to third parties for expenses incurred during its representation of them. These out-of-pocket costs include expenses for travel and meals, court costs, filing fees, expert fees and costs, corporate service charges, third-party photocopy services, deposition costs, long-distance telephone charges, and delivery services (hereinafter, these out-of-pocket costs are collectively referred to as Service Costs). Hughes may or may not enter into written client agreements providing that its clients must reimburse it for the payment of Service Costs. Absent a written agreement, Hughes has no assurance that it will receive reimbursement for any payment of Service Costs. Even with

written agreements, Hughes has no assurance that it will receive reimbursement for its payment of Service Costs because some clients may not honor the agreements.

For all of its taxable years before and including 1989, Hughes consistently deducted Service Costs as ordinary and necessary business expenses when paid, and it consistently included reimbursements of Service Costs in its ordinary income for the year of receipt. Hughes' reporting of Service Costs for tax purposes was the same as for financial accounting purposes, and it corresponded to Hughes' understanding of the manner in which other similarly situated law firms treated their Service Costs.

As of December 31, 1988, Hughes had deducted Service Costs of $490,766 for which it had yet to be reimbursed. During 1989, Hughes paid and deducted $2,367,535 in Service Costs, and included in its income $2,398,825 of Service Costs that were reimbursed during that year. Of the amount reimbursed, $1,908,509 was for Service Costs paid and deducted in 1989 and

$490,766 was for Service Costs paid and deducted in taxable years before 1989.[2]

On March 30, 1992, respondent began an audit of Hughes' 1989 Form 1065.[3] This date was the first time that respondent had audited Hughes' books and records for any taxable year. On page 1 of its 1989 Form 1065, Hughes included a deduction for Service Costs on line 19, "Other Deductions (attach schedule)", and referenced the attached schedule that detailed the types and amounts of these other deductions. The schedule showed 20 categories of expenses, by type and amount, that totaled the $3,788,034 amount shown as Other Deductions on page 1. The

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[2] The parties have stipulated that the $2,398,825 of Service Costs consisted of $1,908,509 in Service Costs paid and deducted in 1989 and $490,766 in Service Costs paid and deducted in taxable years before 1989. The parties have not explained the $450 difference between the total Service Costs and the aggregate of the components thereof.

[3] Two weeks later, as of April 15, 1992, the period of limitations expired with respect to all of Hughes' taxable years before 1989.

amounts in 2 of the 20 categories included a substantial portion of Hughes payments of Service Costs and its receipts of reimbursements therefor. These two categories, labeled "OTHER REBILLABLE EXPENSES" and "REIMBURSEMENTS FROM CLIENTS", showed expenditures of $1,651,941 and reimbursements of $4,627,806, respectively. The $4,627,806 amount shown as reimbursements was shown on the schedule as a negative number. This number was the only "negative expenditure" included in the 20 categories.[4]

Respondent determined that Hughes' Service Costs were loans and adjusted Hughes' 1989 taxable income to reflect this determination. Respondent's adjustment, which was reflected in

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[4] Although the record does not contain the Forms 1065 that Hughes filed for its taxable years before 1989, the parties have stipulated (and testimony at trial supports the fact) that Hughes had consistently followed this practice for reporting its Service Costs on all of its tax returns filed for the pre-1989 taxable years.

her Notice of Final Partnership Administrative Adjustment, was as follows:

Service Costs deducted but not reimbursed on December 31, 1988		$490,766
Service Costs deducted in 1989	$2,367,535	
Service Costs reimbursed in 1989	(2,398,825)	(31,290)
Less: Bad debt deduction[5]		(37,019)
Adjustment to Hughes taxable income for 1989		$422,457

OPINION

Petitioner has conceded the correctness of respondent's determination that the Service Costs must be treated as loans to clients that create neither deductions when paid nor income when reimbursed. The dispute between the parties centers on whether Hughes' 1989 taxable income includes $422,457 that Hughes

[5] Respondent allowed this bad debt deduction for Service Costs that were not reimbursed and were written-off by Hughes.

received during 1989 as reimbursement for Service Costs which Hughes deducted for its pre-1989 taxable years. Respondent argues that Hughes must include this amount in its income under the tax benefit rule. Petitioner counters that the tax benefit rule is inapplicable because Hughes' deductions of Service Costs were improper. Respondent replies that the doctrine of quasi estoppel precludes petitioner from alleging that Hughes' deductions were improper.

The tax-benefit rule includes an amount in current income to the extent that: (1) The amount was properly deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion in gross income. Hillsboro Natl. Bank v. Commissioner, 460 U.S. 370, 383-384 (1983); Frederick v. Commissioner, 101 T.C. 35, 41 (1993). A current event is fundamentally inconsistent with the premises on

which the deduction was originally based when that event would have prevented the deduction if the event had occurred in the year of the deduction. Hillsboro Natl. Bank v. Commissioner, supra at 383-384; Frederick v. Commissioner, supra at 41.

Our decisions apply the tax benefit rule only when the original deduction was proper. We do not apply the tax benefit rule to increase a taxpayer's current income by the amount of a deduction that was taken improperly in a year that is now closed by the period of limitations. Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 559 (1980); Unvert v. Commissioner, 72 T.C. 807 (19.79), affd. on other grounds 656 F.2d 483 (9th Cir. 1981); Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 87-88 (1971), affd. 456 F.2d 622 (5th Cir. 1972). The period of limitations, as previously stated by this Court, "requires eventual repose. The `tax benefit' rule disturbs that repose only if respondent had no cause to question the initial deduction, that is, if the deduction was proper at the time it was taken." Canelo v.

Commissioner, 53 T.C. 217, 226-227 (1969), affd. 447 F.2d 484 (9th Cir. 1971).

Absent the erroneous deduction exception, the tax benefit rule would apply to the instant facts to require Hughes to recognize income in 1989 to the extent that Hughes received during that year reimbursements of any Service Costs that it deducted in taxable years prior to 1989. Respondent argues that we should reconsider our position on the erroneous deduction exception. We decline to do so. See 885 Inv. Co. v. Commissioner, 95 T.C. 156, 165-166 (1990); Davoli v. Commissioner, T.C. Memo. 1994-326; Gmelin v. Commissioner, T.C. Memo. 1988-338, affd. without published opinion 891 F.2d 280 (3d Cir. 1989). Although many Courts of Appeals have criticized or rejected the erroneous deduction exception to the tax benefit rule, see Unvert v. Commissioner, 656 F.2d at 485-486; Union Trust Co. v. Commissioner, 111 F.2d 60, 61 (7th Cir. 1940), affg. Block v. Commissioner, 39 B.T.A. 338, 341-342 (1939); Kahn v. Commissioner, 108 F.2d 748, 749 (2d Cir. 1940), affg. 38 B.T.A. 1417, 1419-1420. (1938);

Commissioner v. Liberty Bank & Trust Co., 59 F.2d 320, 325 (6th Cir. 1932), revg. and remanding Liberty Ins. Bank v. Commissioner, 14 B.T.A. 1428 (1929), the Court of Appeals for the Fifth Circuit, the circuit to which appeal lies in this case, has not squarely addressed the question, see Mayfair Minerals, Inc. v. Commissioner, supra.

Respondent also relies on the doctrine of quasi-estoppel. This doctrine, better known as the duty of consistency, negates the erroneous deduction exception and prevents a party from benefiting in a subsequent year from an error that was made in a prior year. Southern Pac. Transp. Co. v. Commissioner, supra at 559-560. When the duty of consistency applies, the taxpayer must recognize income even though the earlier deduction was improper. Id. at 560; Mayfair Minerals, Inc. v. Commissioner, supra at 89.

The duty of consistency applies when: (1) The taxpayer made a representation or reported an item for Federal income tax purposes in one year, (2) the Commissioner acquiesced in or relied on that representation or report for that year, and (3) the taxpayer

attempts to change that representation or report in a subsequent year, after the period of limitations has expired with respect to the year of the representation or report, and the change is detrimental to the Commissioner. Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986); see also Kielmar v. Commissioner, 884 F.2d 959, 965 (7th Cir. 1989), affg. Glass v. Commissioner., 87 T.C. 1087 (1986); Unvert v. Commissioner, 656 F.2d at 485; Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974); Mayfair Minerals, Inc. v. Commissioner, supra at 87-88. When the duty of consistency applies, the Commissioner may proceed as if the representation or report on which she relied continues to be true, although, in fact, it is not. Simply put, the taxpayer is estopped from taking a position to the contrary. Herrington v. Commissioner, supra at 758.

The first and third elements of quasi-estoppel are clearly present in the instant case.[6] Id. Respondent argues that the second

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[6] According to petitioner, the first and third requirements have not been met because Hughes did not manipulate the facts underlying its deduction of the

element is also present. According to her, Hughes made an inadequate disclosure of its Service Costs on its Forms 1065, and this inadequate disclosure prevented her from making a timely adjustment to Hughes' pre-1989 taxable years. Petitioner counters that the Service Costs were fully disclosed on Hughes' Forms 1065, and, therefore, respondent should have known about the impropriety of these deductions.

The second requirement--i.e., respondent acquiesced in or relied on a representation or report--is met when a taxpayer files a return that contains an inadequately disclosed item and respondent accepts that return and allows the period of limitations to expire without an audit of that return. Herrington v. Commissioner, supra

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Service Costs in order to obtain a tax benefit, and Hughes is not voluntarily changing its treatment of Service Costs. We do not read these requirements so narrowly as to require a manipulation or a voluntary change. See, e.g., Herrington v. Commissioner, 854 F.2d 755, 758 (5th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986); Unvert v. Commissioner, 72 T.C. 807, 816 (1979), affd. on other grounds 656 F.2d 483 (9th Cir. 1981).

at 758. To avoid meeting the second requirement, the taxpayer must provide respondent with sufficient facts to supply her with actual or constructive knowledge of a possible mistake in the reporting of the erroneously disclosed item. Respondent may rely on a presumption of correctness of a return or report that is furnished to her under penalties of perjury, absent sufficient facts to supply her with actual or constructive knowledge to the contrary. As recently stated by the Court of Appeals for the First Circuit, the duty of consistency requires that the taxpayer's misrepresentation "must be one on which the government reasonably relied, in the sense that it neither knew, nor ought to have known, the true nature of the transaction mischaracterized by the taxpayer." Lewis v. Commissioner, 18 F.3d 20, 26 (1st Cir. 1994) (citing Herrington v. Commissioner, supra at 758; Mayfair Minerals, Inc. v. Commissioner, 456 F.2d at 623; Ross v. Commissioner, 169 F.2d 483, 495-496 (1st Cir. 1948), revg. a Memorandum Opinion of this Court), vacating and remanding T.C. Memo. 1992-391.

In the case at bar, we agree with respondent that Hughes did not adequately report its treatment of Service Costs on its pre 1989 Forms 1065 so that respondent knew or should have known that the costs might have been reported incorrectly. Hughes' Forms 1065 for the years relevant herein would not have informed respondent that Hughes was erroneously reporting its Service Costs. The terms "OTHER REBILLABLE EXPENSES" and "REIMBURSEMENTS FROM CLIENTS" that Hughes used to report the Service Costs on its pre-1989 Forms 1065 would not alert respondent to a possible error in the reporting of Service Costs. Thus, absent actual or constructive knowledge of a possible erroneous treatment of an item, we must hold that respondent relied on the representations in Hughes' pre-1989 Forms 1065 that the "OTHER REBILLABLE EXPENSES" were properly deducted as business expenses and the "REIMBURSEMENTS FROM CLIENTS" were properly included in income as reimbursements of deductible business expenses, and, in so relying, allowed the period of limitations for those years to expire. Accordingly, we

conclude that the duty of consistency requires that Hughes consistently report these erroneous items for which an adjustment is now time-barred; i.e., Hughes must continue to report as income the reimbursements of these otherwise nondeductible, but previously deducted, Service Costs. As succinctly stated by the Court of Appeals for the Fifth Circuit: "The duty of consistency is a doctrine that prevents a taxpayer from taking one position one year, and a contrary position in a later year, after the limitations period has run in the first year." Herrington v. Commissioner, supra at 757 (citations omitted).

We have considered all arguments made by the parties, and, to the extent not addressed above, find them to be without merit.[7]

To reflect the foregoing,

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[7] We note that Hughes argued that the recovery of the erroneous deductions was not includable in its 1989 income because Hughes' partners during 1989 were different than Hughes' partners during the years in which the erroneous deductions were taken. We expressly reject this argument as a defense to the duty of consistency. For this purpose, we regard the partnership as an entity.

Decision Will be entered
for respondent.

26 U.S.C. § 61:

GROSS INCOME DEFINED.

(a) GENERAL DEFINITION. - Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) CROSS REFERENCES. -

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).